Investment Commentary

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The U.S. stock market rebounded from its January losses and hit record highs by the end of February with larger-cap stocks gaining 4.6% and tipping into positive territory for the year to date (up 0.9% through February's end). Smaller-cap stocks achieved similar returns. As we saw throughout 2013, these gains occurred despite a continuing stream of mixed (and at times, poor) economic data. In February, some of the more disappointing data releases included a downward revision of fourth-quarter 2013 GDP growth (to 2.4% from 3.2%), which was also sharply lower than last year's strong third-quarter growth number. The month also brought reports of lower-than-expected job growth and retail sales as well as relative weakness in U.S. factory production. (That said, the extreme winter weather in some parts of the country may have affected the data to some extent.) On the positive side, housing, consumer sentiment, and business activity all had favorable updates toward month end. Another reason for market optimism appears to be the Federal Reserve's assessment of U.S. economic strength. As new Fed Chairman Janet Yellen assumed official leadership in February, investors got a sense of her current views through two congressional hearings during the month. She indicated she expects QE tapering to continue, though this could change given a more significant deterioration in U.S. economic data, suggesting that the Yellen Fed won't be quick to remove its support.

Stock market gains extended to international markets and both developed-foreign and emerging-markets stocks were positive in February. Among developed markets, European stocks rose based on increased optimism for recovery—and perhaps lessening concern about deflation. Emerging markets were positive in February, even as civil unrest in Ukraine escalated—and resulted in a month-end rally in defensive assets like Treasurys and gold. Despite slowing growth in China—as the government attempts to manage a potential debt bubble—and this year's rate hikes by countries with some of the harder-hit currencies as of late (India, South Africa, Brazil, etc.), stocks rose alongside other risk assets.

Bonds were slightly positive in February and are up 2% for the year-to-date thanks to their strong returns in January. Overall, the yield on the 10-year Treasury has fallen from the end of 2013, hitting 2.66% at the end of February, down from 3.04% at year end. Municipal bonds have been particularly strong in 2014, following a challenging year in 2013 when headline risk such as Detroit's bankruptcy and Puerto Rico hung over the market. We have maintained our allocations to munis in our taxable portfolios and returns have been solid.

As always, there is a lot of noise in the short-term data, and while the markets seem to react day-to-day based on new headlines, we try to look beyond that. Our view is that the U.S. economy is recovering at a modest pace, below the historical average, while stock valuations seem to reflect artificially high expectations for future growth. This mismatch is part of the reason we have recommended using some alternative asset class strategies in our portfolios. The strategies we utilize typically have a lower correlation to both stocks and traditional bonds, which allows us to build portfolios with improved risk and reward profiles. Some examples of these strategies include diversified arbitrage, market neutral and hedged equity, global macro, real return, absolute return bond funds and precious metals.

In the commentary below, we address the topic of income investing. We think this is a timely topic as we continue to see investors "reach" for yield in today's low interest rate environment.

Income Investing

Thankfully we were early to recognize the secular theme of a rising demand for investment income in an era of low interest rates. Based on demographic trends, slower economic growth (New Normal), monetary policy and other factors we have tilted our portfolios towards higher income from multiple sources, which has resulted in improved returns with lower risk. In essence, we have been able to" have our cake and also eat it too." For many investors, there is an intuitive appeal to owning income-producing investments and living on the cash flow they produce, while leaving the principal untouched. For us it simply came down to valuation and expected return, which we viewed

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as attractive for many years. The challenge going forward is that market appreciation and lower interest rates have caused expected returns to dwindle for many of the strategies we have capitalized on. We believe that investors that are solely chasing yield in today's environment are taking more risk than they realize and are likely to be disappointed with future returns. Our focus today, as always, is on the best expected return which leads us to a total return strategy, discussed below.

For investors looking to fund living expenses through retirement the best approach is to simply seek the best overall return possible, consistent with acceptable risk, and use the return to fund what is required for spending. When it comes to investing, all sources of return, once earned, become part of a broader portfolio measured in dollars, and a dollar taken from that portfolio and used to fund living expenses doesn't know or care whether it came from income or principal. In the commentary below we will walk through specific reasons why we believe a total return approach is a better option than a pure income approach for funding living expenses, particularly in a low-interest-rate environment. We hope that convincing investors of this will pay them dividends in the form of better returns.

WHAT'S WRONG WITH JUST LIVING ON THE INCOME?

In short, the answer—at least for those without a very high ratio of asset to income needs—is there isn't enough income (yield) available in the current market environment. For most investors seeking income, the goal isn't just to fund living expenses; it is to have enough money to last the rest of their life and to keep inflation from eroding the value of their principal. A portfolio limited to vehicles that cast off income will be a less reliable way to achieve those goals, for several reasons.

- An exclusive focus on income limits the opportunity set and rules out sources of return that may be higher. Is an investor really prepared to accept a lower overall return just to have more of it come from income?
- In today's environment, very low yielding high-quality bonds not only generate little income, they expose investors to losses in the value of their bonds when interest rates eventually rise (further).
- Reaching for higher yields may sometimes generate better near-term returns, but at a cost of higher credit risk and less downside protection in an ugly environment for risk assets. There are no free lunches in investing.

In summary, a portfolio that is only invested in high income producing securities is likely to have less diversification and a lower expected return.

The risk side of the equation is of particular concern. Over the years, there have been many examples of products introduced by investment firms that were designed to generate high income returns that subsequently "blew up," suffering losses far above what investors expected or could tolerate relative to their goals. (Just look back to 2008 and the dismal returns of some so-called lower-risk short-maturity income funds.) Today, some of the popular ideas—and ones on which we've gotten many questions—are REITs, MLPs, closed-end bond funds, or flexible bond funds that take on various types of risk, including credit risk or interest-rate risk. While these may have a legitimate place in a portfolio, they need to be evaluated in a broader portfolio context that takes into account an investor's goals and risk tolerance as well as other investment opportunities available at the time. In the current environment of very low bond yields, we've seen too many examples of investors shifting away from bonds toward higher-income investments that present very different risk profiles. High-yield ("junk") bonds, for example, is an asset class that we were buying aggressively in 2008/09, however at today's low absolute and relative yields we are concerned for investors that continue to flood money into the asset class. In early March the spread on high-yield relative to investment grade (Baa) corporate bonds was the lowest it has been since 1984… not my idea of a good value.

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WHAT ARE THE BENEFITS OF A TOTAL RETURN APPROACH?

An investor might cite income as a goal. But what that investor typically means is they are in withdrawal mode and require cash flow from their portfolio to fund living expenses. What really matters is having a sustainable withdrawal plan to determine how much they can realistically take out over time.

Our approach has always been to try to generate the best total return without exceeding a client's risk tolerance. Here are a few reasons why we build portfolios with risk and return, not just income, as our primary focus.

1. Seeking the best return for a given level of risk lets us build better-diversified portfolios. This is especially important because there is always a range of potential economic and market outcomes, and no one can be sure how things will play out. We work hard to get a sense of probabilities and downside severity, but good diversification lets us build portfolios better suited to a variety of outcomes.
2. A total return approach can be more tax efficient. Rebalancing to raise cash by trimming appreciated investments back to target levels can result in gains that are typically taxed at much lower rates than the ordinary income thrown off by an income portfolio. A further opportunity exists to offset gains by realizing losses when it makes sense to do so.
3. An investor who is regularly withdrawing living expenses needs a portfolio that will provide for them far into the future. The term "capital sufficiency" refers to how long a portfolio will last at a given return and withdrawal rate (and, helping make our point, the source of return is irrelevant in computing this). All the while, inflation steadily erodes the value of those dollars. Trading return potential for the sake of current income makes the challenge of meeting financial goals even tougher.

DISTRIBUTIONS AND TAXES

In order to handle actual distributions from a practical standpoint, we employ a couple of strategies. First, we allow the investments we own to pay interest and dividends to cash instead of being reinvested, which creates a cash buffer for upcoming portfolio distributions. Second, if at the time an investor needs to take money out for living expenses and there isn't enough cash, we take the opportunity to rebalance their portfolio. If stocks have done well in relation to bonds, they would likely be over-weighted relative to their target allocations, and we can trim them back to meet the investor's withdrawal needs. Similarly, if the equity markets were down, the investor's bond positions would probably be over-weighted, and so we'd sell some of their bond funds.

Admittedly, this is a bit more work than having a steady stream of income coming in all the time, but it has a couple of key advantages. As we've discussed, in a total-return approach a portfolio can be more diversified and own all kinds of investments: domestic and international equities, smaller-cap stocks, both high-yield and investment-grade bonds, and so on. This diversification has advantages for distributions because it offers more options for rebalancing (it's more likely that something is up—and something is down—in a more diversified portfolio). In contrast, focusing solely on income-oriented investments casts a narrower net and offers fewer options from which to choose.

Furthermore, as we noted earlier, focusing on income generation isn't always very tax efficient. Obviously municipal bonds generate tax-exempt interest, but the yields on those bonds—and indeed most bonds these days—are not very high, so an investor would need to own a lot of them to fund their living expenses (unless they had a very large investment portfolio). A total-return approach enables investors to shift a meaningful portion of their tax liability to long-term gains. Whenever cash is needed to cover additional expenses, the portfolio can be reviewed for securities that can be sold with the least onerous tax consequences associated with them. This could include investments with long-term gains (which are taxed at a lower rate than income), or possibly even investments that are underwater and generate tax losses. In a diversified, total-return-oriented portfolio, an investor has more control, and greater potential, to maximize after-tax returns.

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CAPITAL SUFFICIENCY—IT HELPS TO HAVE A PLAN!

The other essential part of investing during the distribution phase is truly understanding each investor's income needs and evaluating their resources for meeting them. For our clients I suggest doing a capital sufficiency (financial plan) analysis to assess sustainable retirement income withdrawals. In what we believe is likely to be a lower return environment for some years ahead, it is critical to use realistic and conservative assumptions in determining what rate of withdrawal is possible over longer periods. But returns are only a guess, and ultimately, the only factor that can be controlled with any certainty is the investor's rate of withdrawal and spending. We always hope to generate returns that are better than our assumptions, and reassessments over time can generate confidence that higher withdrawals can be taken safely. But getting the trajectory wrong early on can create lasting problems. Therefore, opting for a realistic, conservative withdrawal rate is essential.

A FINAL WORD

Letting go of the idea that distributions must only come from investment income (bond coupon payments, dividends, etc.) creates the opportunity to build a more diversified, more durable, potentially higher-returning portfolio strategy. In the end, we believe that whether an investor meets investment objectives and capital sufficiency will be driven by overall return, not necessarily where it came from.

—Steve Giacobbe, CFA, CFP (3/14)